

activities, including a detailed explanation of the methodology used to attribute costs; publication of BT's interconnection agreements and of the amounts attributed to Network Components and Parts, and charges for Standard Services; non-discrimination requirements to oblige BT Network to set transfer charges to BT Retail Systems on the same basis as the interconnection charges to other operators; a requirement upon BT not to discriminate between itself and other operators in respect of the quality of service offered .

4.8 However, the way in which charges are set will be quite different in the new regime. There will no longer be annual determinations of charges by the Director General. Instead the new arrangements will give BT flexibility to set charges within a framework of network charge caps and other rules. The remainder of the chapter sets out the details of how the new regime will operate.

Inland conveyance services in the new regime

4.9 One difference between the current and new regimes arises from the classification of conveyance services. In the current interconnection regime there are three main inland conveyance services purchased by interconnecting operators: local exchange segment, single tandem segment, and double tandem segment. In the proposed new regime the services bought by operators will be classified slightly differently and, as set out in the sections below, different regulatory controls will apply to each of the main types of conveyance.

4.10 In the new regime there will be two local exchange segment services, one for call termination and one for call origination. The charge for a call termination local exchange segment will be set in the call termination basket; the charge for a call origination local exchange segment will be set in the general network basket. A single tandem segment will be composed of two services in the new regime: a local exchange segment (either call origination or call termination) and local-tandem conveyance. The charge for the latter will be set by BT in the general network basket. A double tandem segment will be made up of three services: a local exchange segment (either call origination or call termination), local-tandem conveyance, and inter-tandem conveyance. The charge for inter-tandem conveyance will be set by BT under safeguard caps. A fuller comparison of standard interconnection services in the new and current regimes, and the regulatory treatment proposed by OFTEL, is set out at Annex G.

COMPETITIVE SERVICES (NO NETWORK CONTROLS)

4.11 OFTEL proposes that charges for two services should be outside of network controls, because of the degree of competition that already exists and the expected development of competition before the start of the network controls on 1 August 1997:

- * Directory Enquiries
- * Operator Assistance

These two services will account for around 10% of the revenues of BT Network (excluding payments to other operators).

4.12 In the second consultative document OFTEL also suggested that some inland private circuits

should be free of network controls. OFTEL's reconsideration of its proposals for these circuits is discussed below.

Directory Enquiries (DQ)

4.13 A number of respondents to the second consultative document suggested that it would be premature to conclude that DQ will be competitive by August 1997, before the final outcome of OFTEL's consultation exercise on directory information is known. Rather than no network controls, they suggested that DQ should be covered by a safeguard cap, which could be removed as soon as the market became competitive.

4.14 In the separate consultation on directory information two options are being considered. One option is to allow competing core databases to be set up, which would provide competition to BT's numbering information service (NIS). The other option is for there to be a single core database, but managed by an agency or joint venture, rather than exclusively owned by BT. Operators or service providers would be able to obtain directory information from the database and would be able to compete in the provision of directory enquiry products. Under either option, therefore, OFTEL anticipates that vigorous competition will develop in DQ services. OFTEL does not, therefore, consider that a safeguard cap for BT's DQ service is necessary and proposes that DQ should be free of network controls.

4.15 From 1 August 1997 the current standard interconnection services relating to DQ will be unbundled into two elements: inland conveyance and use of BT's directory enquiry service. Neither element will be subject to network controls, but see paragraphs 4.43 to 4.44 for a further discussion of charges for the inland conveyance element.

4.16 If a single database model were adopted, regulatory action might be required to control the price and quality of access to that database. This would be analogous to the current controls on BT's services of inputting data to and downloading data from the NIS database, although BT might no longer be the controller of the single database. If there were competing databases, BT's large share of customer connections might mean that continued regulatory scrutiny of the terms of supply of its raw customer information might be necessary. In either case proposals will be formulated separately from the price control review, as part of the consultation process on directory information.

Operator assistance

4.17 In the second consultative document OFTEL suggested that operators should be encouraged to self-provide operator assistance services and that there are no significant barriers to entry. In its response, the Cable Communications Association argued that BT has a considerable advantage over other operators because of economies of scale and that operator assistance should (initially at least) be subject to a safeguard cap. OFTEL remains to be convinced about the importance of economies of scale in this market, but considers that there are no barriers to third parties setting up such services to realise any economies of scale that may exist by supplying operator assistance to a number of different operators. In any case, if there were a disparity in economies of scale, it should lessen over time as other operators, individually and collectively, increase their customer bases. OFTEL

proposes, therefore, that there should be no network controls for operator assistance.

4.18 As for DQ, the interconnection services relating to operator assistance are composed of an inland conveyance element and a 'value-added' element (BT's operator assistance). Both elements will be removed from network controls. However, OFTEL's proposed approach to the inland conveyance element is discussed further in paragraphs 4.43 to 4.44 below.

Inland private circuits

4.19 The proposed treatment of inland private circuits in the second consultative document reflected the proposal that Condition 46 of BT's licence should be deleted. This proposal had been put forward as part of OFTEL's consultation on the Fair Trading condition in December 1995. In the second consultative document, therefore, OFTEL proposed that all private circuits should be charged to operators as interconnection services, but that there would be no network controls on high capacity private circuits or analogue private circuits. For low capacity digital private circuits, inclusion in the general network basket was suggested.

4.20 Many of the respondents to both the price control and fair trading consultations argued that private circuits should not be charged as interconnection services but should continue to be priced as retail services. If private circuits were to be charged as interconnection services, they suggested that investment in competitive infrastructure would be seriously undermined. In the light of these responses, OFTEL has reconsidered its position. It is now of the view that the current arrangements for the pricing of inland private circuits as retail services for operators, except those who are not authorised by a licence to self-provide, should continue. However, OFTEL proposes that the detailed determination power contained in Condition 46.2-46.5 should be removed. Inland private circuits will account for some 30% of the costs of BT Network. OFTEL's position on international private leased circuits is discussed in paragraphs 4.27 to 4.28 below.

PROSPECTIVELY COMPETITIVE SERVICES (SAFEGUARD CAPS)

4.21 Prospectively competitive services are those that are not expected to be competitive by August 1997, but are expected to become competitive during the next control period. OFTEL proposes to regulate the charges for such services outside a network basket using safeguard caps of RPI+0% on each discrete charge. It is expected that the binding constraint on charges will be imposed by the pressures of competition rather than the safeguard cap. During the control period, safeguard caps will be removed from services which are determined to be competitive under the process set out in Condition 16B.6 of BT's licence.

4.22 OFTEL proposes three types of interconnection service as prospectively competitive:

- * inter-tandem conveyance
- * international direct dial (IDD) conveyance
- * international private leased circuits (IPLCs)

These services will account for some 15-20% of the revenue of BT Network.

Inter-tandem conveyance

4.23 In the second consultative document OFTEL proposed that inter-tandem conveyance should be classified as a prospectively competitive service and should be regulated by safeguard caps of RPI+0%. Few responses challenged this approach.

4.24 There is a number of different (though closely related) services which are inter-tandem interconnection services. For example, the current sub-division of the basic inter-tandem conveyance service into three services by distance band (up to 100 kilometres, between 100 and 200 kilometres, and greater than 200 kilometres) will remain. In addition, there are variants on the basic service which use the same network components but with different routing factors, such as inter-tandem transit (which involves an additional tandem switching stage) and inter-tandem conveyance for international direct dial (which is not sub-divided into distance bands).

4.25 OFTEL proposes that each discrete charge for each inter-tandem conveyance service should be governed by a safeguard cap of RPI+0%. OFTEL would expect that BT will base its charges for inter-tandem services on the same component rates, so that differences in the charges will arise only from differences in routing factors. If BT were to use different component rates for different inter-tandem services, OFTEL might conclude that BT was behaving in an unduly discriminatory or anti-competitive manner, unless BT could provide adequate reasons to justify its charges.

International direct dial (IDD) conveyance

4.26 As set out in the second consultative document, OFTEL proposes to classify IDD conveyance on each country pair route as a prospectively competitive service to be regulated by a safeguard cap of RPI+0%. If at some point during the price control period any particular IDD interconnect market is judged by the Director General to be competitive, the safeguard cap will be removed for that market. A small number of respondents argued that there should be no network controls on IDD conveyance. A few suggested that safeguard caps would provide insufficient protection for interconnecting operators. However, most respondents agreed with OFTEL's approach. OFTEL proposes therefore that each discrete charge for IDD conveyance set by BT, excluding the gross outpayment to overseas operators, will be subject to a safeguard cap of RPI+0%.

International private leased circuits

4.27 In the second consultative document OFTEL proposed that international private leased circuits (IPLCs) should be outside of network controls on the assumption that the UK will implement the liberalisation of all international routes before or during the next control period. Many respondents suggested that IPLCs should be subject to a safeguard cap on each country pair route, and that the safeguard caps could be removed as appropriate when liberalisation has occurred and after new operators have had time to finalise arrangements to enter the international markets. OFTEL considers that this would be a preferable approach and proposes to classify IPLCs as prospectively competitive interconnection services, with each discrete charge governed by a safeguard cap of RPI+0%.

4.28 For IDD conveyance and for IPLCs, if liberalisation and the take-up of new facilities licences were to proceed rapidly, the Director General might conclude that certain international markets were competitive before August 1997. If this were the case, the safeguard cap for that route would not be needed and the route would be removed from the safeguard controls before the new arrangements came into force in August 1997, using the process under Condition 16B.6 for BT or another operator to request that the Director General determine a service to be competitive. On the other hand, if the Department of Trade and Industry were to decide not to pursue the liberalisation of all international routes, OFTEL's proposals for IDD conveyance and for IPLCs would need to be reconsidered.

CALL TERMINATION SERVICES

4.29 As argued in the second consultative document OFTEL considers that call termination in general can be regarded as an area of bottle-neck control and as such should be regulated by a separate basket. The bottle-neck arises because, once a customer has chosen to become connected to the access network of a particular operator, anybody wishing to call that customer (and the operator conveying the incoming call) would have no choice but to terminate the call on the chosen operator's network. Call termination will account for around 15-20% of the revenues of BT Network.

4.30 In principle, OFTEL sees the bottle-neck as covering that part of BT's network from the network side of the lowest part of the network hierarchy at which operators can practically and economically interconnect through to the customer-side of the concentrator, ie the local exchange segment. OFTEL does not agree with some respondents who suggested that the bottle-neck necessarily starts at the point of interconnection, typically the tandem switch, where other operators' calls are handed on to BT for final delivery. At present there is relatively little competition for the provision of links between tandem and local switches and OFTEL does not consider that such links can be expected to become competitive during the next control period. But there is nevertheless the likelihood of competition in the provision of such links over the longer term.

4.31 In the second consultative document OFTEL suggested that, exceptionally, where topology or low traffic volumes at the local switch make the provision of a point of interconnect or a link from the tandem switch clearly uneconomic, it might be appropriate to class this connection as part of the bottle-neck. However, OFTEL has noted the comments of respondents who suggested that implementing this approach would be resource intensive, would amount to micro-management of the market and might be impractical. While the logic of OFTEL's position remains unchanged, for practical reasons OFTEL proposes to simplify the arrangements by defining call termination always from the local switch and never from the tandem switch.

4.32 This approach implies that the call termination 'basket' will only include one service, the local exchange segment. It will avoid the need for a potentially complex and time-consuming set of arrangements to determine which of the local switches will be inappropriate for the commencement of the call termination service. For operators that continue to interconnect with BT at a tandem switch, call delivery will involve purchasing two interconnection services from BT: a local exchange segment for call termination and local-tandem conveyance. Only the former will be included in the call termination basket, but the charge for the latter will be regulated because it will be included in the general network basket and, like all other interconnection services, will also be constrained by

the rules concerning floors and ceilings.

INTERCONNECTION SERVICES IN THE GENERAL NETWORK BASKET

4.33 OFTEL proposes that the following types of service should be included in the general network basket:

- * call origination
- * local-tandem conveyance
- * single transit

These services will account for around 25% of the revenues of BT Network.

Call origination

4.34 Call origination is defined in an analogous fashion to call termination, ie from the customer-side of the concentrator to the network side of the local switch. As for call termination, OFTEL now proposes that the local switch should always be the cut-off point for the call origination service and never the tandem switch. Charges for call origination on BT's network will be paid both by BT Retail Systems and by indirect access operators.

4.35 Some respondents suggested that call origination on BT's network is a bottleneck. However, OFTEL does not consider that call origination is a bottleneck service in the same way as call termination. The key difference between call origination and termination is that, for origination, the customer that ultimately pays the call origination charges is the individual who makes the choice of which network to obtain an access line from. With call termination the caller pays for the call, but it is the recipient that has the choice of network access. Local access operators are providing increasing competition to BT for call origination, but OFTEL does not consider that there will be sufficient competition in this market over the next price control period. OFTEL proposes that the call origination local exchange segment should therefore be a service in the general network basket.

Local-tandem conveyance

4.36 As BT itself accepts, the competition to local-tandem conveyance on BT's network is significantly weaker than the competition for some other services, such as inter-tandem conveyance. It is anticipated that competition with local-tandem conveyance on BT's network will increase over time, but not to the extent that it would be appropriate to regard this service as prospectively competitive for the forthcoming control period. Therefore, OFTEL confirms its proposal that conveyance between local and tandem switches will be included in the general network basket.

4.37 Although BT will have flexibility to set the charge for local-tandem conveyance, there are various constraints that will influence its choice. The charge that it sets will be paid not only by interconnecting operators, but also by BT Retail Systems. In addition, since local-tandem conveyance will have a significant weight in the general network basket, any increase in its charge would require significant reductions in the charges for other services in the basket, in order to comply with the overall RPI-X constraint. Furthermore, OFTEL may investigate charges that are

alleged to be anti-competitive, unduly discriminatory, or unfair under conditions of BT's licence or the proposed Fair Trading condition and in line with the approach of floors and ceilings discussed in paragraphs 4.61-4.64 below.

Single transit

4.38 Single transit involves the use of a single switch, typically a tandem switch but possibly a local switch, but no transmission over BT's network. Single transit interconnection would occur where there is no (convenient) point of interconnection between two operators' networks, but both have a point of interconnection with BT at the same BT switch. OFTEL proposes to include single transit in the general network basket.

THE TREATMENT OF OTHER INTERCONNECTION SERVICES

4.39 Other interconnection services include access to Number Translation Services, the inland conveyance elements of DQ and operator assistance, interconnect specific services, and access to emergency services.

Access to Number Translation Services (NTS)

4.40 Access to Number Translation Services includes access to BT's Freephone, Lo-call, National Call and Premium Rate Services. The determination made in January 1996 for access to NTS specifies that the originating operator will pay to BT the Deemed Retail Price for the call on the basis that BT covers the originating operator's costs of conveyance over its own network by paying the originating operator the rate determined for a single tandem segment on BT's network (plus an allowance for the originating operator's additional retail costs). The Deemed Retail Price depends upon which of BT's services is being accessed.

4.41 OFTEL proposes that the basis of the determination for access to BT's NTS should continue to apply, and this will be incorporated in the interconnection guidelines which will be produced in due course. The payments made by BT to originating operators for access to NTS should therefore be based upon the charges for a call origination local exchange segment and local-tandem conveyance that are set by BT under the general network basket, plus an allowance for retail costs. The payments made by originating operators to BT should be related to the retail price. BT Network will be remunerated by BT Retail Systems for the usage of BT's network, ie both the digital derived services network and inland conveyance. Payments which do not comply with this approach may be viewed as anti-competitive or unfair.

4.42 Some respondents argued that similar rules should determine the flow of payments in the opposite case, ie where BT provides call origination for access to another operator's NTS. OFTEL agrees and its view that the NTS determination should in principle apply generally, regardless of whether BT were the terminating operator or the originating operator, was set out in the determination of Interim Charges for 1995/96.

Inland conveyance for access to DQ and operator assistance

4.43 As outlined above, the interconnection services relating to DQ and operator assistance will be unbundled into two elements: a 'value added' element and inland conveyance, with the value added element free of network controls because of the degree of competition that is expected. The ability to self-provide DQ and operator assistance could provide some competitive constraint on BT's charge for the inland conveyance element as well as the value added element. This is because an operator with the ability to self-provide will be comparing the cost of self-provision, which will generally not involve conveyance on BT's network, with the charge for obtaining the service from BT, which will include the inland conveyance element. However, if the operator's alternative to purchasing the service from BT were to purchase from a service provider, inland conveyance on BT's network might be needed to access the service provider and the competitive constraint imposed on the inland conveyance element of BT's service could be relatively weak.

4.44 OFTEL does not propose to include the inland conveyance elements associated with DQ and operator assistance in a network basket, but it would expect that the charges set by BT should be no higher than if they were based on the same interconnection service (and component rates) that will be set by BT under the inter-tandem conveyance safeguard caps and the general network basket. For example, OFTEL will expect that the charge for 'inland conveyance for access to BT's directory assistance' would be no higher than if it were derived from the same component rates as for inter-tandem conveyance (although the level of the charge might differ due to differences in the relevant routing factors). Similarly, OFTEL will expect that BT's charge for 'inland conveyance for access to BT's operator assistance' would be no higher than if based on the interconnection service charges set under the general network basket and the inter-tandem safeguard cap. If the charges for the inland conveyance elements were higher than if based on the charges set under the caps, OFTEL would consider investigating as behaviour that might be anti-competitive, unduly discriminatory or unfair.

Interconnect specific services

4.45 Interconnect specific services comprise access to the numbering information system (NIS), interconnection circuits and data management amendments. In 1994/95 the fully allocated cost of all of these services taken together was just 21 million, less than 1% of the costs of BT Network. Although the amount of money involved is not significant in the context of BT Network's total revenue, the payments made for these services may be significant to the operators who pay them and OFTEL is currently reviewing the appropriate basis for charging for all of these services. For this reason, OFTEL does not now propose to regulate their charges in a network basket (as proposed in the second consultative document under the heading 'interconnect specific basket'). Instead OFTEL proposes to separate consideration of the charges for these services from the present review and from the design of the network charge controls.

4.46 The appropriate basis for charging for all of these services is currently the subject of separate reviews by OFTEL. These reviews will be completed in time to have new arrangements to replace the determination of charges for these services by 1 August 1997. The services currently provided by BT for access to NIS, and the appropriate basis for charges, fall to be considered as part of the review of directory information which OFTEL is undertaking. For interconnection circuits and data management amendments, as part of its project reviewing residual barriers to competition, OFTEL

is currently examining whether the costs of provision should be shared between BT and the other operators, rather than recovered in full by BT from the other operators. For points of connection, cost sharing is already partially allowed for in BT's licence, since Condition 13.5C.1 provides for sharing of the costs of establishing the connection. OFTEL intends for the present to retain this provision, which includes a power of determination, but it will review whether the principle of cost sharing should be extended to cover transmission capacity. OFTEL will also consider whether the principle should be applied to data management amendments.

Emergency services

4.47 In the current interconnection regime, the charges for access to BT's emergency service are determined by the Director General. OFTEL proposes that the charges for this service will be unbundled into two elements: conveyance to BT's emergency operators and the operator service itself. As for DQ and operator assistance, the charge for the inland conveyance element should be no higher than if based on the charges set under the general network cap and safeguard caps, taking account of the specific routing factor for this service. The charge for the emergency operator service will be subject to a safeguard cap to ensure that BT does not raise the charge unduly. However, BT will be able to apply to the Director General for consent to exceed the limit set by the safeguard cap if it can demonstrate that not to increase charges would endanger the quality and security of the emergency service.

Product management, policy and planning

4.48 In the current regime product management, policy and planning is a component, not a service. It is paid only by interconnecting operators, because it relates to the costs that are specific to interconnection, arising, for example, from interconnect finance and billing and from the BT personnel who manage interconnect relationships. Currently, these costs are recovered on a pence per minute basis from interconnecting operators, with the same pence per minute charge for each inland conveyance interconnection service purchased. In 1994/95 the costs of product management, policy and planning were 22 million, less than 1% of the costs of BT Network.

4.49 In the new regime, the basis of charging for product management, policy and planning will be the same as in the current regime, ie a pence per minute 'surcharge' for each interconnection minute. For a given call, an interconnecting operator may purchase a number of interconnection services under different caps including safeguard caps, eg call termination local exchange segment and local-tandem conveyance and inter-tandem conveyance (all three together constitute a double tandem segment in the current regime). BT will need to ensure that there is only one surcharge for each interconnection minute and not a surcharge for each service, when more than one service is purchased for a given interconnection minute. Since the costs of this component are paid solely by interconnecting operators and not by BT Retail Systems, OFTEL will be monitoring closely the component rate set by BT to ensure that it is not excessive. If there were allegations that the component rate for product management, policy and planning were set too high by BT, OFTEL would consider investigating as behaviour that might be anti-competitive, unduly discriminatory or unfair.

THE STARTING LEVELS OF THE NETWORK BASKETS

4.50 For the start of the network controls on 1 August 1997, BT will need to make changes to its interconnection charges to comply with the constraint set by OFTEL governing the starting levels of the network baskets. Figures giving the starting levels are not contained in this document, but will be set by OFTEL early next year. BT will need to ensure that the charges that it sets to apply from 1 August 1997 for interconnection services in any basket, multiplied by the prior financial year (ie 1996/97) volumes of those services, is less than or equal to the allowable revenue for that basket set by OFTEL. The change in the average charge for services in the basket during the first year of the network controls will, as in subsequent years, be governed by the RPI-X constraint and the constraint on the weighted average date. In the first year, the RPI-X constraint will require that by 31 July 1998 the reduction in the average charge in real terms must be at least as large as X compared to the average charge on 1 August 1997, with the weights to be applied to the individual services given by the revenue shares in the prior financial year, 1996/97. The weighted average date constraint on the timing of the changes in charges will require that the effect of such price changes, whenever they occur, is at least as large as if the price reductions (in real terms) had occurred on 1 February, the midpoint of the network control year.

4.51 For each of the call termination and general network baskets an allowable revenue will be set for 1 August 1997. The allowable revenue for each basket will be given by the forecast of the initial unit cost of each of the services in the basket, multiplied by the volume of each service in the prior financial year, 1996/97. For the purpose of calculating the allowable revenue, the unit cost of each interconnection service will be calculated as a forecast of BT's incurred average incremental cost of the service plus an equal proportionate mark-up rate for common costs.

4.52 As proposed in the second consultative document, OFTEL will base the starting level of the network baskets on BT's incurred costs rather than the costs of an efficient operator, because in general it does not favour one-off adjustments. The results of the further work on the incremental cost models will be used to derive BT's incurred long run incremental costs of inland conveyance and the common costs of the network.

4.53 The incremental cost models cover inland conveyance, but there are a number of interconnection services that have not been modelled in the incremental cost work. Estimates will be made of the incremental costs of those services that are not included in the incremental cost models, such as IDD conveyance, DQ and data amendments. While the costs of these services are required in order to apportion the common costs using equal proportionate mark-ups, all of these services will either be covered by safeguard caps or no network controls will apply and so an allowable revenue for these services will not need to be forecast.

4.54 The common costs will be apportioned between interconnection services (inland conveyance plus the services that are outside the incremental cost models) and access, in proportion to their relative incremental costs using equal mark-ups, to yield the cost base for the network. Incremental costs for 1 August 1997, plus a share of the common costs given by the equal proportionate mark-up rate, will be forecast to give the unit costs of services in the call termination basket and the general network basket.

Starting charges for the safeguard caps

4.55 For the purpose of apportioning the common costs, an equal proportionate mark-up will also be applied to the incremental costs of services to be covered by safeguard caps and those to be outside of network controls. For the services in safeguard caps, however, no initial allowable revenue will be set. The safeguard cap of $RPI+0\%$ will apply to the interim charges that have been determined by the Director General for the period April to July 1997 under the current interconnection regime (fully allocated costs using historic cost accounting). The final charges to apply for the period April to July 1997 will not be determined before August 1998. OFTEL proposes no retrospective adjustment of the starting points of the safeguard caps even if the final charges turn out to be different from the interim charges, because this would introduce an unnecessary degree of uncertainty and instability. It should also be recalled that the binding constraint on services in safeguard caps should be provided by competitive pressures - competition should force BT to move its charges for such services towards forward looking incremental costs.

Reconciliation of top-down and bottom-up models

4.56 Work has been undertaken to reconcile the top-down and bottom-up incremental cost models for 1993/94. This work has involved comparing the results of the models to identify the differences and the reasons for those differences in terms of methodology or parameter value. The reconciliation has been largely successful in accounting for the differences between the models. Before the starting levels of the network baskets are set, further work to reconcile the results of the incremental cost models will be useful in improving the robustness of the figures.

4.57 Using the information derived from the comparison of the models for 1993/94, 'hybrid' figures for incremental cost have been produced, which draw upon both of the models, by identifying where possible the appropriate methodology and parameter values. The starting levels of the network baskets will be based on BT's incurred incremental cost plus mark-up and not the efficient level of cost. The 'efficiency gap', the difference between BT's incurred costs and the costs of an efficient operator, feeds into the value of X. The hybrid numbers for incremental cost produced as a result of the reconciliation work constitute the assessment of BT's incurred incremental costs. The reconciliation has also sought to identify whether a robust inference can be drawn that all or a part of the difference between the results of the top-down and bottom-up models derives from differences in efficiency.

4.58 The main reasons why the results of the models might differ include variations in:-

- * the level of operating costs
- * the investment cost (or gross replacement cost) of a given piece of capital equipment
- * the amount of capital equipment required for a given level of output, ie utilisation rates
- * the approach adopted to annualise the cost of capital equipment, eg economic depreciation or straight line depreciation plus holding gain/loss
- * cost of capital

- * modelling approach (eg the bottom-up model assumes that there are no direct routings between two local switches, whereas the top-down model includes such routings; the bottom-up model assumes point-to-point transmission, whereas the top-down approach models multiplexed transmission)

4.59 Comparisons have been made between the incremental cost models, component by component. Full details of the reconciliation work are set out in the report prepared for OFTEL by NERA, copies of which are available from OFTEL's library.

FLEXIBILITY OF BT'S CHARGE SETTING

4.60 In the second consultative document OFTEL addressed four different types of flexibility, relating to:

- * floors and ceilings
- * varying charges by end-use
- * varying component charges between different interconnection services
- * stability of charges

Floors and ceilings

4.61 The floors proposed by OFTEL are related to incremental cost and the proposed ceilings are related to stand-alone cost. The floors and ceilings are intended to set what will generally be the limits for charges, subject to OFTEL's assessment of specific allegations of excessively high or excessively low charges. The proposed approach of floors and ceilings should be considered in the context of OFTEL's intention to move away from detailed and intrusive regulation towards acting as a competition authority for the telecommunications industry.

4.62 All firms in the economy operate under general competition laws and may be subject to investigation about their pricing. For the network controls OFTEL proposes to adopt specific floors and ceilings to give a greater degree of transparency and certainty to BT and interconnecting operators. The range given by floors and ceilings will determine the burden of proof in an investigation. If a charge were to lie within the floor and ceiling, the burden of proof would lie with the complainant to show that the charge could be expected to be anti-competitive, unduly discriminatory or unfair. If a charge were to be set below the floor or above the ceiling, the burden of proof would lie with BT to demonstrate that the charge would not have these effects. This is consistent with the approach suggested for wider use in the draft guidelines on the operation of the proposed Fair Trading licence condition.

4.63 It is not common practice for competition authorities to set out in advance ranges of prices, outside which there would be a presumption of anti-competitive behaviour. Nevertheless OFTEL will publish values of floors and ceilings for the inland conveyance network components to prevail for the first year of the network controls before August 1997. OFTEL does not intend to publish floors and ceilings for other components (eg relating to international conveyance) which are not

included in the incremental cost models. Updated floors and ceilings for inland conveyance components will not be published by OFTEL as a matter of course, although a mid-term review of floors and ceilings will occur in 1999 and OFTEL will then publish figures to provide guidance to the industry. OFTEL will, however, investigate as appropriate in response to allegations that BT's charges are anti-competitive, unduly discriminatory or unfair. OFTEL will ensure that BT provides it with sufficient disaggregated information on a regular basis to enable OFTEL to deal quickly with any allegations of unfair pricing. OFTEL will ensure that operators are aware of the type of information that BT is required to supply, although it may not appropriate for all of it to be published.

4.64 OFTEL has not produced figures for floors and ceilings for the first year of the network controls for the same reasons that it has not been possible to derive firm figures for the starting levels of the network baskets. The incremental cost models and their reconciliation would benefit from further work, and the quality of forecasts for the first year of the next control period would be greatly improved by the availability of further and more up-to-date cost information.

Flexibility by end use

4.65 As in the second consultative document, OFTEL proposes that there should be a presumption against flexibility by end-use, but not a ban on such flexibility. OFTEL notes the concerns expressed by many respondents about allowing charges to vary by end-use, particularly about BT requesting detailed and possibly commercially sensitive information about other operators' use of services. Any proposal by BT to set charges differentiated by end-use would only be permitted if BT were able to convince OFTEL that any such charges would have no anti-competitive effect and were not unduly discriminatory or unfair.

Component rates

4.66 As in the second consultative document, OFTEL proposes that the rate for any particular component should be the same for all interconnection services within the same basket, but that the component rates may differ between services in different baskets.

Notice period for changes in charges

4.67 In the second consultative document OFTEL argued that the importance to interconnecting operators of stability in charges needs to be balanced against BT's legitimate desire to alter charges to reflect changing market conditions. OFTEL suggested that the key requirements are that charges should be transparent and that there should be reasonable notice of changes in charges. OFTEL proposed that BT should give 60 days' notice of any changes in its interconnection charges and that it would be required to make publicly available each set of charges for interconnection services and the amounts attributable to Network Components and Parts.

4.68 A large number of respondents commented on this proposal. Some agreed that 60 days was a reasonable notice period. BT argued that 28 days would be more appropriate. Others suggested that 60 days would provide insufficient notice, at least for some services. A number of respondents

argued that there should be a longer notice period for services in the call termination and interconnect specific baskets. Amongst these respondents there was no consensus about the appropriate notice period, with suggestions ranging from 90 days to a requirement that BT's charges should be fixed for the whole year (and announced three months before the start of the year).

4.69 OFTEL is attracted by the idea that there should be different notice periods for services facing different competitive constraints. It proposes that the notice period for changes in the charges for competitive and prospectively competitive services should be 28 days, and that the notice period for services in the two network baskets should be 90 days. These notice periods imply that BT should announce the charges to apply on 1 August 1997 by the 4 July for competitive and prospectively services and by 3 May for services in the two network baskets.

4.70 OFTEL's proposals to allow BT much greater flexibility than at present in setting and varying interconnection charges are part of an overall approach, which includes the proposed Fair Trading licence condition, discussed earlier in this document. The new regime with increased freedom for BT will only be successful if OFTEL has the powers to police allegations of anti-competitive behaviour speedily and effectively.

CALL TERMINATION ON OTHER NETWORKS

4.71 As set out in the second consultative document, OFTEL's position remains that it favours the principle of reciprocity for setting charges for call termination on other operator's networks, but it does not intend to impose the principle by way of detailed regulations.

4.72 OFTEL notes, however, that different operators appear to place a different interpretation on the term 'reciprocity'. OFTEL's view of reciprocity is equal payments in each direction for broadly similar types of network, when calls pass in both directions between networks over the same point of interconnection. This would mean that, if an operator were to interconnect with BT at a local exchange, the payment that it would receive from BT for call termination would be the same that it pays BT, which under the proposed new regime of network baskets would be the local exchange segment rate in the call termination basket. If an operator were to interconnect with BT at a tandem switch, it would receive the same payment that it makes to BT for call delivery, which under the proposed new regime would be the sum of the local exchange segment rate in the call termination basket and the charge for local-tandem conveyance in the general network basket.

4.73 In its response to the second consultative document, the Cable Communications Association raised the question of what reciprocity would imply if the traffic from BT's network to the network of another operator were conveyed across a different point of interconnection from that used to carry traffic from the other operator to BT's network (eg if the former were at a BT tandem switch and the latter at a BT local switch). OFTEL proposes that the payment to be made by BT to the other operator should be related to the BT switch from which interconnection occurs. If BT were to use a point of interconnection at a local switch on its network to convey traffic for termination on the other operator's network, it would pay the other operator the charge for a local exchange segment for call termination on BT's network, which in the new regime will be set by BT in the call termination basket. If BT were to use a point of interconnection at a tandem switch on its network

to convey traffic for termination on the other operator's network, it would pay the other operator the charge for a single tandem segment on BT's network, which in the new regime will be the sum of the charges for the local exchange segment set by BT in the call termination basket, and for local-tandem conveyance set by BT in the general network basket.

4.74 If calls pass from BT's network to the other operator's network over a different point of interconnection from calls in the opposite direction, the payments made by BT would be independent of the payments made by other operators to BT for call delivery. The payments made by another operator to BT will depend upon the type of BT switch at which it chooses to interconnect for the traffic that it sends to BT for call delivery. If interconnection occurs at a BT local switch, the other operator will pay the charge for a call termination local exchange segment. If interconnection occurs at a BT tandem switch, the other operator will pay the sum of the charges for a call termination local exchange segment and for local-tandem conveyance.

INTERACTION OF NETWORK AND RETAIL CAPS

4.75 The second consultative document contained an extensive discussion of the interaction of network and retail caps and the question of the pass-through of network charges into the retail cap. OFTEL concluded that substantial problems concerning incompatibility of the levels or structures of the caps were unlikely to arise and that pass-through was not required. Responses to the document have not raised any new issues. Therefore, OFTEL continues to propose separate retail and network caps.

LICENCE MODIFICATIONS

4.76 A set of draft licence modifications to introduce the new network controls is at Annex D. These modifications are not the subject of statutory consultation. OFTEL will put forward firm proposals for statutory consultation early next year. It will continue to develop the modifications through discussion with BT and other operators. It hopes to complete the discussions, covering all aspects apart from the final values of the starting levels of the network baskets and the values of X, towards the end of the year when it intends to hold a further informal consultation on the licence modifications.

4.77 The licence modifications at Annex D are developments of the modifications that were set out in Annex A to the second price control consultative document. They move many of the Director General's powers of determination in the area of interconnection, but some essential powers must be retained. The minimum retentions include the Director General's power to direct that services should be provided under Condition 13.1(c), and the power to determine some standard services as operating in competitive markets (or that competitive conditions no longer apply), under Condition 16B.6.

4.78 OFTEL has considered the possibility of linking the removal of determination powers with the requirements under the EU Directives for dispute resolution procedures. OFTEL has concluded that it would be preferable to separate these issues. The proposal to retain essential determination powers is subject to the qualification that, when the final shape of the requirements under the Directives is known, there might be a need for further modification.

4.79 OFTEL is considering separately, under its project examining residual barriers to competition, whether a general power to require cost sharing would be desirable. OFTEL does not for the moment propose to delete the specific provisions for sharing the costs of equal access in Condition 13A.6, even though the Director General does not intend to use the powers in this condition at present.

4.80 The network licence modifications include a number of minor changes consequential to the introduction of the network charge controls, and the deletion of powers of determination. One change, however, is more substantive: the modifications include provisions for the charges agreed to be paid by BT under an interconnection agreement for the use of the other operators' networks to be governed by the terms of other operators' licences, rather than, as at present, by BT's licence. This was previously included in Annex A to the second consultative document, but the proposed licence modifications are now more extensive. In the course of discussions with operators about these proposed modifications, OFTEL will explore what parallel modifications may be required to other operators' licences to allow for incremental cost based interconnection charges.

Information and transparency

4.81 It will be important that other operators have at least as much confidence in the derivation of the interconnection charges that they will pay under the new regime, as they have in the current regime. The Interconnection and Accounting Separation system will remain in place, in particular the requirement for BT to provide separate regulatory accounts that will identify cross-subsidies and prevent undue discrimination.

4.82 OFTEL will be discussing with BT the changes that will be needed to reflect the move from the determined charges based on fully allocated costs using the historic cost accounting convention, to charges subject to network controls based on long run incremental costs. These changes will include: the provision of current cost accounting financial statements to the same detail and quality of audit as applies to the present historic cost accounts; the review of the Accounting Documents which form the basis on which the regulatory accounts are drawn up; the introduction of revised components, which give a more unbundled and transparent view of costs (see Annex G); and the investigation of appropriate sources for, and visibility of, the information required to establish the floors and ceilings for charges.

**MCI'S INITIAL COMMENTS TO THE DEPARTMENT OF JUSTICE
CONCERNING THE MOTION TO VACATE THE JUDGMENT AND
NYNEX'S REQUEST TO PROVIDE INTEREXCHANGE SERVICE
IN NEW YORK STATE**

United States v. Western Elec. Co., et al.

Civil Action No. 82-0192 (D.D.C.)

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structural separation. Not surprisingly, the Ninth Circuit recently found the FCC's action unjustified. *California v. FCC*, 1994 U.S. App. LEXIS 29001 (9th Cir. Oct. 18, 1994); *California v. FCC*, 4 F.3d 1505, 1512-13 (9th Cir. 1993). As the Ninth Circuit recognized, actual experience in information services markets "shows that the BOCs have the incentive to discriminate and the ability to exploit their monopoly control over the local networks to frustrate regulators' attempts to prevent anticompetitive behavior." 1994 U.S. App. LEXIS, at *30-31.

Like dangers of discrimination in the type and quality of access, problems of cross-subsidy and price discrimination remain as intractable as ever. The BOCs' principal claim is that "price caps eliminate incentives and opportunities to engage in cross-subsidization." BOC Mem. 37.^{35/} But, as actually implemented by the FCC and only some states, incentive regulation plans have not eliminated the anticompetitive incentives admittedly created by rate of return regulation because those plans "have not divorced rates from rate of return." Kelley Decl. 41; Hall Decl. 8 ¶ 22, 44-45 ¶ 118; Cornell Decl. 39-44 ¶¶ 85-98. Moreover,

^{35/} Here, as elsewhere, movants imply that the D.C. Circuit resolved this issue and other issues in their favor in *United States v. Western Elec. Co.*, 993 F.2d 1572 (D.C. Cir.), cert. denied, 114 S. Ct. 487 (1993). BOC Mem. 29, 32, 41; NYNEX Mem. 23-24, 26, 28. That distorts this decision. As the Court of Appeals made clear, it did not decide whether BOC claims about the effectiveness of regulation were valid; it decided only that these claims had a sufficient evidentiary basis to support a waiver of a line of business restrictions under the lenient standard applicable to an uncontested BOC petition. 993 F.2d at 1578, 1582.

BOCs still have the ability to insinuate cross-subsidies into their networks through the way that they design them (for example, by building excess capacity into "official services" network in anticipation of interexchange relief). Kelley Decl. 45-46; see *MFJ Opinion*, 552 F. Supp. at 189 n.238.^{36/}

The BOCs cite imputation rules as a significant regulatory safeguard. BOC Mem. 39. But imputation rules are not self-executing or self-enforcing, and they cannot prevent the BOCs from manipulating costs that constitute a major portion of the cost of providing interexchange service. Cornell Decl. 51-55 ¶¶ 112-20, 57 & n.139 ¶ 125 (Illinois decision finding violation of imputation rules by Ameritech), 55-58 ¶¶ 121-26 (intraLATA toll), 58-63 ¶¶ 127-38 (pay-phones). Other accounting rules are equally ineffective, especially in light of the imperfect information that the

^{36/} The BOCs' affiants suggest that the BOCs would provide interexchange services within their regions using excess capacity in their already existing intraLATA and interLATA official services networks. *E.g.*, Barro Aff. 8; Hausman Aff. 23; Schmalensee Aff. 9; Wm. Taylor Aff. 44-45. However, regulators would surely be surprised to learn that the BOCs have built excess interLATA capacity into networks paid for by captive local ratepayers. See Hall Decl. 50 ¶ 133. When MCI questioned whether the BOCs made excessive investments in their fiber networks (particularly their official services networks) in anticipation of future removal of the interexchange restriction, the BOCs claimed that the capacity was limited to that needed to support exchange and exchange access services. See In the Matter of MCI's Petition for Immediate Investigation of BOC Recovery of Costs Associated with Recent Dramatic Expansion of BOC Facilities and Operations (filed with FCC on April 9, 1987). In any event, the BOCs fail to show that the cost of their own existing fiber capacity is less than the cost of existing capacity of legitimate interexchange providers. Hall Decl. 50 ¶ 134; see *id.* at 28 ¶ 71, 29 ¶ 75 (discussing active lease market for fiber transmission facilities).

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December 13, 1996

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Re: Competitive Impact of Bell Operating
Companies' Entry Into Long Distance

Dear Mr. Russell:

AT&T submits these responses to the questions of the U.S. Department of Justice dated November 21, 1996, concerning the competitive impact of entry by the Bell Operating Companies ("BOCs") into in-region interLATA ("long distance") services under Section 271 of the Telecommunications Act of 1996.

QUESTION 1: What potential benefits, if any, do you foresee resulting from Bell Company entry into long distance? Specifically, what do you see as (a) the present state of competition in the provision of long distance services and the likely development of further competition absent near term Bell entry; and (b) the likely competitive impact of near term Bell entry into the long distance market?

RESPONSE a: There is currently robust competition in the provision of long distance services. Such competition has dramatically increased over the past decade and will continue to be vigorous absent entry by the BOCs.

separation are now sunk, and local exchange and interexchange markets operate efficiently today on a separated basis.

Moreover, section 272 of the Telecommunications Act of 1996 clearly precludes this type of "integration" by the BOCs in the provision of local and long-distance service. As described in greater detail in the recently-filed comments of the Department, AT&T and others concerning the FCC's proposed rules to implement Section 272, the fundamental purpose of the structural separation provisions of Section 272 is to prohibit the integrated provision of exchange and interexchange services by the BOCs or their affiliates. Such integration would be inherently discriminatory because unaffiliated interexchange carriers would be incapable of similarly integrating their facilities with the BOCs' exchange facilities. (Section 251(g) also precludes this kind of discrimination.) It would also make cost misallocations and cross-subsidies a certainty by creating a large pool of claimed joint and common costs from which inherently arbitrary allocations would then have to be made."

As to retail efficiencies, under Section 272(g), the BOCs and their affiliates will be able to offer consumers one-stop-shopping. Under Section 272(g)(1), a BOC affiliate will be permitted to purchase and resell the BOC's local exchange service in conjunction with the affiliate's own interexchange service (provided unaffiliated carriers have the same opportunity). Under Section 272(g)(2), a BOC will likewise be permitted to market and sell the interexchange services on behalf of its affiliate pursuant to an arm's length agreement through which its affiliate purchases those marketing services. Thus, integrative efficiency in the marketing, billing and customer support for the provision of local and long distance services would be expected.

RESPONSE b: Although the Section 272 separation requirements apply only to the BOCs (because of their market power over the provision of local exchange service), the ability of interexchange carriers to achieve "integrative efficiencies" generally would be limited, as a practical matter, to the extent that such carriers could acquire (or construct) and operate facilities that could be used both to provide interexchange and exchange services. By any measure, duplication of the BOCs' local

⁴⁶ See Reply Comments of the United States Department of Justice, pp. 10-12, Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended (filed August 30, 1996) ("DOJ Reply Comments"); Comments of AT&T Corp., pp. 16-52, Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended (filed August 15, 1996); Reply Comments of AT&T Corp., pp. 14-29, Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended (filed August 30, 1996).

UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

UNITED STATES OF AMERICA,)

Plaintiff,)

v.)

Civil Action No. 82-0192 HHG

WESTERN ELECTRIC COMPANY,)

INC. and AMERICAN TELEPHONE)

AND TELEGRAPH COMPANY,)

Defendants.)

MEMORANDUM OF THE UNITED STATES IN RESPONSE
TO THE BELL COMPANIES' MOTIONS FOR GENERIC WIRELESS WAIVERS

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